

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 97-42**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Application of the Tennessee income tax on dividends and interest to a foreign partnership and to its Tennessee general partner.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

Partnership I, a Tennessee limited partnership, is considering becoming a 99% general partner in a newly formed [STATE A - NOT TENNESSEE] limited partnership (Partnership II). The [STATE A] partnership would be organized principally for the purpose of owning and managing certain shares of common stock presently held by Partnership I. Partnership II's sole source of income would be dividend income from the stock which it holds, as well as any interest earned on such dividend income while it is held in the partnership's account. It is likely that any interest income will be nominal due to the fact that Partnership II intends to distribute any earnings to its partners immediately upon their receipt.

The remaining 1% limited partnership interest in the [STATE A] partnership would be held by an individual domiciled in Tennessee. This individual would receive his 1% interest in Partnership II in exchange for a pro-rata contribution of cash or other valuable personal property.

The [STATE A] partnership agreement would explicitly provide that, if Partnership I attempted to transfer its interest in Partnership II, Partnership II would dissolve by operation of [STATE A] law. Under [STATE A] law, the general partnership interest would be nontransferable. In addition, the partnership agreement would significantly restrict the limited partner's ability to participate in the management of the partnership.

Partnership II will be capitalized primarily through the contribution of shares of common stock presently owned by Partnership I. Any certificates evidencing ownership in such shares will be physically transferred to a custodian account maintained by a [STATE A] financial institution. In addition, Partnership II will open a checking account in a [STATE A] bank for purposes of receiving and distributing any income which the partnership may earn. No accounts or property will be owned or maintained by Partnership II in the state of Tennessee.

Contemporaneous to the formation of the Partnership II, Partnership I proposes to form a trust (Trust) under [STATE A] law, naming either a [STATE A] resident individual or a [STATE A] financial institution as the trustee. In forming the Trust, Partnership I will retain a beneficial interest in both the income and principal held by the trust. Partnership I will assign its general partnership interest in Partnership II to the Trust and that interest will comprise the sole corpus of the Trust.¹ Because of the assignment, the Trust will step into the shoes of Partnership I with regard to its general partnership interest in Partnership II. The trustee will be granted general powers with respect to the management of the Trust corpus. These powers would include, but not be limited to, the performance of all partnership management functions, the execution of contracts related to the administration of the partnership, and the investment of any undistributed income earned by the partnership. The trustee would, however, be restricted as to his/her authority to vote the shares by the partnership.

The trustee in [STATE A] will perform all management functions related to the operation of Partnership II including the management of the investments it holds. The trustee will be independent of Partnership I and will exercise his powers independently of Partnership I. Partnership I will have no right to control Partnership II and will take no part in the management functions of Partnership II. However, Partnership I will have the right to appoint the [STATE A] trustee and to dismiss such trustee.

Under the plan described in these facts and under the alternative plan described in the footnote to these facts, there will be no instrument whereby Partnership II will be required to pay interest to the Trust or to Partnership I.

Currently, Partnership I has 1 general partner and [NUMBER] limited partners. The sole general partner is a Tennessee based corporation who retains a 1% interest. The same Tennessee domiciliary who will hold a 1% limited partnership interest in the proposed [STATE A] partnership holds a 15% limited partnership interest in Partnership I. The

¹ The taxpayer states that it is currently uncertain whether the assignment of the partnership agreement to the Trust would violate the nontransferability provisions in the partnership agreement. If a determination is made by counsel that dissolution would result, the implementation of the proposed structure would simply be altered in such a manner that Partnership I would first contribute the stock directly to the Trust. The Trust would, in turn, enter into the partnership agreement with the Tennessee limited partner to form a partnership, in which the Trust would be the general partner, that would be capitalized primarily by the contribution of the stock held by the Trust.

remaining 84% of limited partnership interests in Partnership I are distributed evenly among [NUMBER] non-Tennessee trusts, the beneficiaries of which are not Tennessee residents.

The taxpayer states that the proposed transactions will not be sham transactions and that all business conducted by Partnership I, Partnership II and the Trust will be conducted in good faith through bona-fide arms-length transactions. The taxpayer further states that Partnership I will not, directly, indirectly or in any other manner, exercise or attempt to exercise, any type of control over Partnership II or the Trust. The Department of Revenue is issuing this Letter Ruling under these assumptions and on the basis of the facts presented.

QUESTIONS PRESENTED

1. Can a foreign partnership be subject to the Tennessee income tax on dividends from stocks and interest on bonds?
2. If the answer to question 1 above is “yes”, is Partnership II subject to the Tennessee income tax on dividends from stocks and interest on bonds?
3. Is income generated from Partnership I’s general partnership interest in Partnership II subject to the Tennessee income tax on dividends from stocks and interest on bonds?

RULINGS

1. Yes.
2. No.
3. No.

ANALYSIS

1. **A FOREIGN PARTNERSHIP HAVING TENNESSEE DOMICILE
OR RESIDENCE AND HAVING TAXABLE DIVIDEND OR INTEREST
INCOME THAT CAN BE ATTRIBUTED TO TENNESSEE IS SUBJECT TO
THE TENNESSEE INCOME TAX**

A Partnership Is A Separate Legal Entity

The modern trend of both the courts and legislative bodies is to treat a partnership as a legal entity separate from its partners for certain purposes. *Tax Review Board v. Belmont Laboratories Company*, 141 A.2d 234 at 238 (1958). The Tennessee State Attorney General’s Office has opined that a partnership should be treated as a separate legal entity

in Tennessee for purposes of taxation. Op. Att’y Gen. 83-340 (1983). Thus, a partnership is considered a legal entity separate from its partners for purposes of the Tennessee income tax.

The Tennessee Income Tax Is Applicable To Partnerships
Having Tennessee Domicile Or Residence

T.C.A. § 67-2-102 imposes the Hall Income Tax as follows:

“An income tax in the amount of six percent (6%) per annum shall be levied and collected on incomes derived by way of dividends from stocks or by way of interest on bonds of each person, partnership . . . in the state of Tennessee who received, or to whom accrued, or to whom was credited during any year income from the sources above enumerated . . .”

Under T.C.A. § 67-2-101(5) quoted below, the term “person” can also mean a partnership, and a partnership is subject to the Hall Income Tax if it is domiciled in Tennessee, or maintains a residence in Tennessee for more than six months.

‘Person,’ ‘it,’ or any other singular pronoun means . . . [a] partnership, . . . in receipt of dividends from corporate stocks and/or interest on bonds as herein defined, regardless of the sources from which such income is derived, Any person who has a legal domicile in Tennessee shall be subject to the tax hereby imposed; every person who maintains a place of residence in Tennessee for more than six (6) months in the tax year shall be subject to the tax herein imposed, regardless of what place such a person may claim as a legal domicile;

It has frequently been held that domicile or residence, more substantial than mere presence in transit or sojourn, is an adequate basis for taxation, including income taxation. *Miller Bros. Co. v. State of Maryland*, 74 S.Ct. 535 (1954). Thus, domicile or residence within a state is a valid basis for the imposition of an income tax by such state. 85 C.J.S. *Taxation* § 1090(b). It is well established that a person, or in this case a partnership, may establish several residences, but can have only one domicile. *Svoboda v. Svoboda*, 454 S.W.2d 722 (Tenn. App. 1969), Cert. Den. Oct. 6, 1969.

For Tennessee corporate tax purposes, “commercial domicile” is defined by T.C.A. § 67-4-804(a)(3) as the principal place from which the trade or business is conducted. This is the definition derived from the Uniform Division of Income for Tax Purposes Act (UDITPA), a model act prepared by the National Conference of Commissioners on Uniform State Laws. *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (1994). Where a partnership is considered to be an entity, it has domicile for tax purposes at the place where its business is conducted. 84 C.J.S. *Taxation* § 328; *In Re Svoboda and Hannah*, 142 N.W.2d 328 at 334 (1966). Accordingly, a partnership’s domicile is defined in the same way as the domicile of a corporation and the same basic criteria for determining domicile apply.

Since commercial domicile is the place from which a business is managed or directed, a partnership interest is regarded as having situs at the place where the business of the partnership is carried on. See: *Associated Partnership I, Inc. v. Huddleston*, supra at 198 and *McKinney v. Nacogdoches Independent School Dist.*, 489 S.W.2d 161 at 169 (Tex. Civ. App. 1972), citing 51 Am. Jur., *Taxation* § 486.

Attribution of Partnership Dividend and Interest Income

The Tennessee income tax is not a tax on the privilege of doing business in Tennessee. In enacting the Tennessee income tax, it was the intent of the Legislature to provide for the assessment and collection of taxes upon property that paid no ad valorem tax. The Legislature chose not to tax the income from the purchase and sale of stocks and bonds, but only the dividends and interest accruing on stocks and bonds. The object of the Tennessee income tax statute was to raise revenue, not by taxing the value of the bond, the value of stocks, or “income” derived from dealing in such securities, but to tax the interest and dividend income produced by the stocks and bonds on which no ad valorem tax had been paid. *First National Bank of Memphis v. McCanless*, 207 S.W.2d 1007 at 1009 and 1010 (Tenn. 1948)

However, Tennessee can not impose any tax in such a way that it violates the United States Constitution. Generally, the due process and commerce clauses of the United States Constitution prohibit states from imposing an income-based tax on values earned outside their borders. But a state may tax income from interstate operations if a fair apportionment formula is provided. 71 Am. Jur., *Taxation* §§ 574-576; *Luhr Bros., Inc. v. Director of Revenue*, 780 S.W.2d 55 at 57 (Mo.banc 1989). *Complete Auto Transit, Inc. v. Brady*, 97 S.Ct. 1076 (1977) sets forth a four prong test that may be applied in considering whether a state can impose a tax without constitutional violations. To meet constitutional muster under *Complete Auto Transit*, the activity of the taxpayer must be sufficiently connected to the taxing state to justify the tax, the tax must be fairly related to benefits provided the taxpayer, the tax must not discriminate against interstate commerce and the tax must be fairly apportioned.

A state may constitutionally tax income fairly attributable to events or transactions occurring within the state and subject to state regulation and protection. 71 Am. Jur., *Taxation* § 574. The enjoyment of the privileges of domicile or residence within a state and the attendant right to invoke the protection of its laws are inseparable from the responsibility for sharing the costs of government. A tax measured by the net income of residents is an equitable method of distributing the burden of government among those privileged to enjoy its benefits. Such a tax is founded on the protection afforded by the state to the income recipient, the recipient’s right to receive, enjoy and control the income, and the economic advantage the income recipient enjoys. *Herndon v. West*, 393 P.2d 35 (Idaho 1964) citing 85 C.J.S. *Taxation* § 1090(b).

The Commerce Clause requires that a tax not discriminate against interstate commerce. In taxing a partnership, Tennessee will not undertake to tax any interstate activity carried on outside its borders. Only income from stocks, bonds and mutual funds purchased, held, managed, and controlled from Tennessee will be taxed.

Other business entities with which a partnership does business, such as banks and brokers, may be located in other states and may conduct their business activities in other states. However, when all of a partnership's dividend and interest income results from investments that it holds, manages and controls from Tennessee, the partnership's business activities which give rise to such income are conducted in Tennessee. The mere fact that a partnership with a Tennessee domicile or residence has a bank account in another state or the fact that it does business with brokers located in other states does not ordinarily give other states the right to tax its dividend and interest income. However, if another state in which a partnership does business should tax the partnership's income, that state would either have to fairly apportion the income taxed, or tax only the income resulting from partnership activities in that state. Thus, Tennessee's taxation of dividend and interest income earned due to activities here would not result in multiple taxation.

Conclusion To Ruling On Question 1

Tennessee has no jurisdiction to tax dividends and interest earned by a foreign partnership having no residence or domicile in Tennessee. However, a foreign partnership having Tennessee domicile or residence is subject to the Tennessee Income Tax if it has dividend or interest income of a taxable nature that can be attributed to Tennessee without the application of an apportionment formula. A partnership is entitled to a \$1,250 exemption under T.C.A. § 67-2-104(a), so the first \$1,250 of dividends and interest of a taxable nature are not taxed.

A partnership's dividend and interest income is attributed to the state in which the investment activities giving rise to the income are conducted. Investment activities, such as decisions to acquire, hold, manage or dispose of investments that earn dividend or interest income, are almost always performed at the partnership's place of domicile.

Although it may be factually possible to structure a partnership in such a way that all investment activities occur at an office or place other than the partnership's domicile, a Tennessee domiciled partnership's dividend and interest income can not be attributed to another state or country, simply because the partnership's governing body makes investment decisions at its annual meeting outside Tennessee, or because the person in charge of investments makes a point to be somewhere outside the borders of Tennessee every time he or she makes a decision or performs an act pertaining to investments. In such a case, the investment activities would be performed at the partnership's office where the employee(s) responsible for the partnership's investment activities are based.

2. PARTNERSHIP II IS NOT SUBJECT TO THE TENNESSEE INCOME TAX

Partnership II will be a [STATE A] partnership that maintains no accounts or property in Tennessee. It's only connection with Tennessee will be that it's 1% limited partner, who is an individual, lives in Tennessee and Partnership I, its 99% general partner, is a Tennessee partnership. However, under the facts given, neither the 1% limited partner nor the 99% general partner have any part in the control or management of Partnership II.

Partnership I will assign its general partnership interest to the Trust and will have no part in the management or control of Partnership II's investments. Certificates evidencing ownership of such investments will be in a custodial account in a [STATE A] financial institution and will be managed and controlled from [STATE A] by the [STATE A] trustee. The only power that the Tennessee Partnership I will retain is the power to appoint or dismiss the trustee.

Under the alternative plan described in the footnote to the facts given, the [STATE A] Trust, rather than Partnership I, will be the general partner in Partnership II, but the Trust will still manage and control Partnership II from [STATE A] and will manage Partnership II's investments from [STATE A].

Partnership II will have its domicile and its only residence in [STATE A]. Tennessee has no jurisdiction to subject Partnership II to the Tennessee income tax.

3. INCOME FROM PARTNERSHIP I'S GENERAL PARTNERSHIP
INTEREST IN PARTNERSHIP II IS NOT SUBJECT TO
THE TENNESSEE INCOME TAX

The Tennessee partnership, Partnership I, will be the beneficiary of the [STATE A] foreign trust. T.C.A. § 67-2-111 makes the following provisions concerning foreign trust beneficiaries:

(a) Any resident of Tennessee who receives income from a trust estate located without the state of Tennessee, any portion of which is invested in securities, the income from which is taxable under this chapter, whether the trust estate be revocable or irrevocable, shall file with the commissioner, as part of the resident's income tax return, a sworn statement of the trustee, executor or other administrator of the trust estate showing what portion of the total income received by such Tennessee resident from such estates was derived from securities, the income from which is taxable under this chapter.

(b) If such resident fails to file such sworn statement from the trustee, executor or other administrator, then the resident shall report for income taxation in the manner otherwise provided in this chapter the entire amount of income received by the resident from such trust estate.

Partnership II will receive dividend income from the stock investments it holds and will earn a nominal amount of interest. Partnership II will immediately distribute such income

to its partners. However, Partnership I's 99% general partnership interest in Partnership II has been assigned to the Trust. So the Trust, rather than Partnership I, will receive 99% of Partnership II's dividend and interest income.

If the foreign [STATE A] Trust receives dividends or interest of a taxable nature, Partnership I, as a beneficiary, must comply with T.C.A. § 67-2-111 and pay the Tennessee income tax on such income.

However, the [STATE A] Trust will own no "stock" or transferable partnership interest defined as "stock" by T.C.A. § 67-2-101(6). The stock earning the dividends will be owned by Partnership II. Therefore, the income that the Trust receives from Partnership II can not be considered taxable "dividends on stocks" under T.C.A. § 67-2-102.

Under the facts given and under the alternative plan described in the footnote to the facts given, there will be no instrument whereby Partnership II will be required to pay interest to the Trust or to Partnership I. Therefore, the Trust will not own a "bond" as defined by T.C.A. § 67-2-101(1) and the income that the Trust will receive from Partnership II can not be taxable "interest on bonds" under T.C.A. § 67-2-102.

Under the alternative plan described in the footnote to the facts given, the [STATE A] Trust, rather than Partnership I would be the general partner in Partnership II but, as a general partner, the distributions to the Trust from Partnership II would not be considered dividends or interest under Tennessee law for the same reasons explained above in regard to the assignment of the general partnership interest to the Trust.

Since the Trust will not earn dividend or interest income, under T.C.A. § 67-2-111 the foreign Trust beneficiary, Tennessee Partnership I, will not be subject to the Tennessee income tax on any Trust income.

If Partnership I has dividend and/or interest income of a taxable nature that can be attributed to Tennessee, the Tennessee income tax will be applicable to such income. But, under the facts given, income generated from Partnership I's general partnership interest in Partnership II will not be subject to the Hall income tax.

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APPROVED:

Ruth E. Johnson, Commissioner

DATE:

10-14-97